

An overview of Transfer Pricing



WIRC of ICAI

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Agenda

- ⌘ Transfer Pricing Origin, Evolution and Basic Concepts
- ⌘ TP – Indian Perspective
- ⌘ Indian Transfer Pricing Regulations v OECD TP Guidelines
- ⌘ Nuances
- ⌘ Case Study



Transfer Pricing (TP) Origin, Evolution and Basic Concepts



Evolution of transfer pricing

- ⌘ It is estimated that, 60 % of international trade is carried on between related or Associated Enterprises (AEs)
- ⌘ To counter the effect of transfer of profits using favourable transfer prices among AEs, many developing and developed countries introduced Transfer Pricing Regulations (TPR)
- ⌘ The TPR have increased the burden of proof on taxpayers, to demonstrate arm's length price of controlled transaction



Evolution of TPR...

- ⌘ Embedded in the Double Taxation Avoidance Agreement ('DTAA') Article 9 of the OECD Model Convention
- ⌘ The OECD Report on Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the Guidelines), is the Foundation
- ⌘ Based on Arm's Length Principle – The universal principle which is the foundation of TP legislation globally

Above principles serve the dual objective

- a) Securing the appropriate tax base in each jurisdiction**
- b) Avoiding double taxation**

Arm's Length standard – The Universal Standard (ALS)

⌘ The Arm's length Standard (ALS) is the Universal Standard that is applicable to the various intra-group transactions of a Multinational Enterprise (MNE). It is based on the separate – entity approach and is enshrined in the DTAA's signed by the various countries.



Transfer Pricing (TP) – Indian Perspective



Brief History & Background of Indian TPR

- ⌘ Liberalization of trade and foreign exchange policy started in India in the year 1991
- ⌘ This created huge increase in interest of MNEs in India



- ⌘ Several Indian companies also steadily emerged as global players by either making offshore acquisitions or by setting up overseas subsidiaries

- ⌘ The Standing Committee in March 1991 observed that provisions of Income Tax Act, 1961(Act) were inadequate to curb transfer pricing among MNEs



Brief History....

⌘ The Expert Group constituted by Central Board Of Direct Taxes (CBDT) recommended complete revision of existing section 92 of the Act

⌘ The Finance Act, 2001 introduced TPR in India by substituting existing Section 92 of the Act and introducing new sections 92A to 92F w.e.f. April, 2001

⌘ The Finance Act, 2012 amended TPR for domestic transactions w.e.f. AY 2013-14. This was an outcome of suggestions given by Honorable SC in **CIT v Glaxo SmithKline Asia (P) Ltd. (236 CTR 113)**



TPR in India

⌘ Section 92 - Income arising to “Associated Enterprises” from “International Transactions” (or Specified Domestic Transactions w.e.f AY 2013-14) shall be computed having regard to the “Arm’s Length Price”



⌘ OECD TP Guidelines lays the foundation of the Transfer Pricing Regulation in India

⌘ Preconditions:

⌘ Two or more associated enterprises;

⌘ Enter into an international transactions

⌘ Specified Domestic Transaction (w.e.f AY 2013-14)

⌘ Consequence:

⌘ Income to be computed having regard to the arm’s length price



Arm's Length Price

⌘ Section 92F(ii) of the Indian TPR

“arm's length price means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions”

⌘ Under Rules 10A to 10E of Income Tax Rules, 1962

“Uncontrolled transaction” – transaction between enterprises other than associated enterprises, whether resident or non-resident

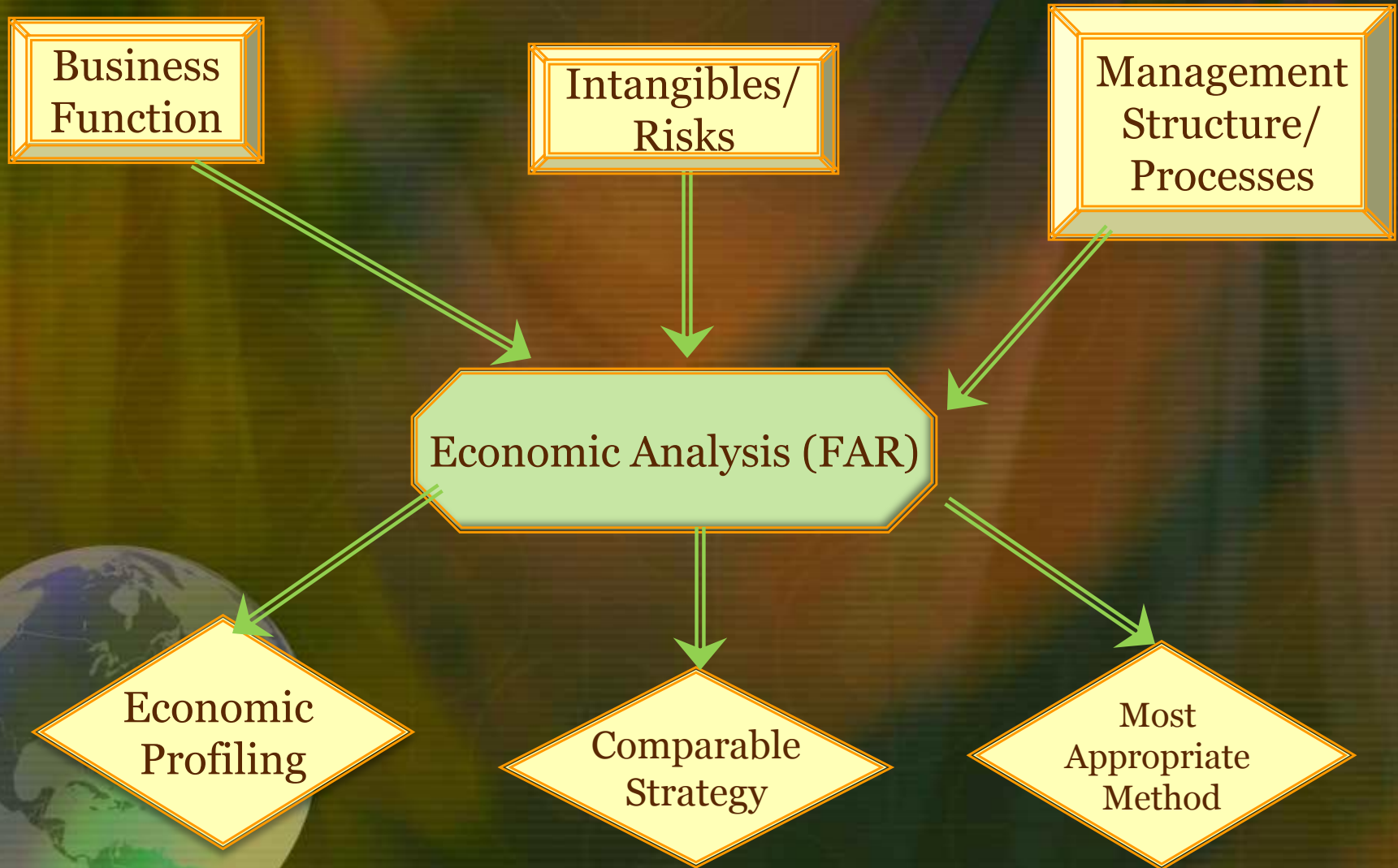


Arms Length Principle

⌘ Prices set for transactions between group entities should, for tax purposes, be derived from prices which would have been applied or proposed to be applied by unrelated parties in similar transactions under similar conditions in the open market.



Functional, Asset and Risk Analysis ?



International transaction

⌘ Means “transaction” between 2 or more Associated Enterprises:

- Transaction between two or more associated enterprises
(at least one of which will be non-resident) of purchase,
sale or lease of tangible and intangible property,
provision of services, financing, cost sharing /
cost
contribution arrangements

OR

- affecting profits, losses, income, assets or liability of the enterprise



International Transactions (Amendments by Finance Act, 2012)

⌘ The expression “International Transaction” has been amended by Finance Act, 2012 w.e.f 1.04.2002

⌘ As per the Act the International Transaction specifically includes:

⌘ Inter-company Guarantees,

⌘ Advance payments, deferred payments, receivables,

⌘ Business restructuring / reorganisation,

⌘ Purchase / sale/ use of intangibles such as customer lists, customer contracts, customer relationships,

⌘ Transfer / secondment of trained employees, etc.



Specified Domestic Transactions

⌘ The Finance Act,2012 has introduced TPR for specified domestic transactions

⌘ Specified Domestic Transactions to include :

⌘ Expenditure in relation to which payment has been made to related party

⌘ Transfer of goods or services between two units, undertakings or companies which are related and one of them is eligible to avail deduction under Chapter VI-A, 80IA

⌘ Any transaction in Chapter VI-A or Section 10AA to which the transfer pricing clause under section 80IA are specifically made applicable

⌘ Any other transaction as may be prescribed



Applicability to Domestic Transactions w.e.f AY 2013-14

- ⌘ Assessee has to file Form 3CEB in respect of Specified Domestic Transactions entered into with their related parties
- ⌘ Minimum Threshold: INR 50 millions
- ⌘ May amount to double taxation in certain cases
- ⌘ All existing TP compliance requirements, mandatory documentation, TP audits (assessments) and penalty provisions will be applicable



Most Appropriate Method (MAM)

⌘ The Act prescribes selection of the MAM from the six specified methods; having regard to the nature of transaction or class of transaction or class of associated persons or functions performed by such persons or such other relevant factors as the Board may prescribe

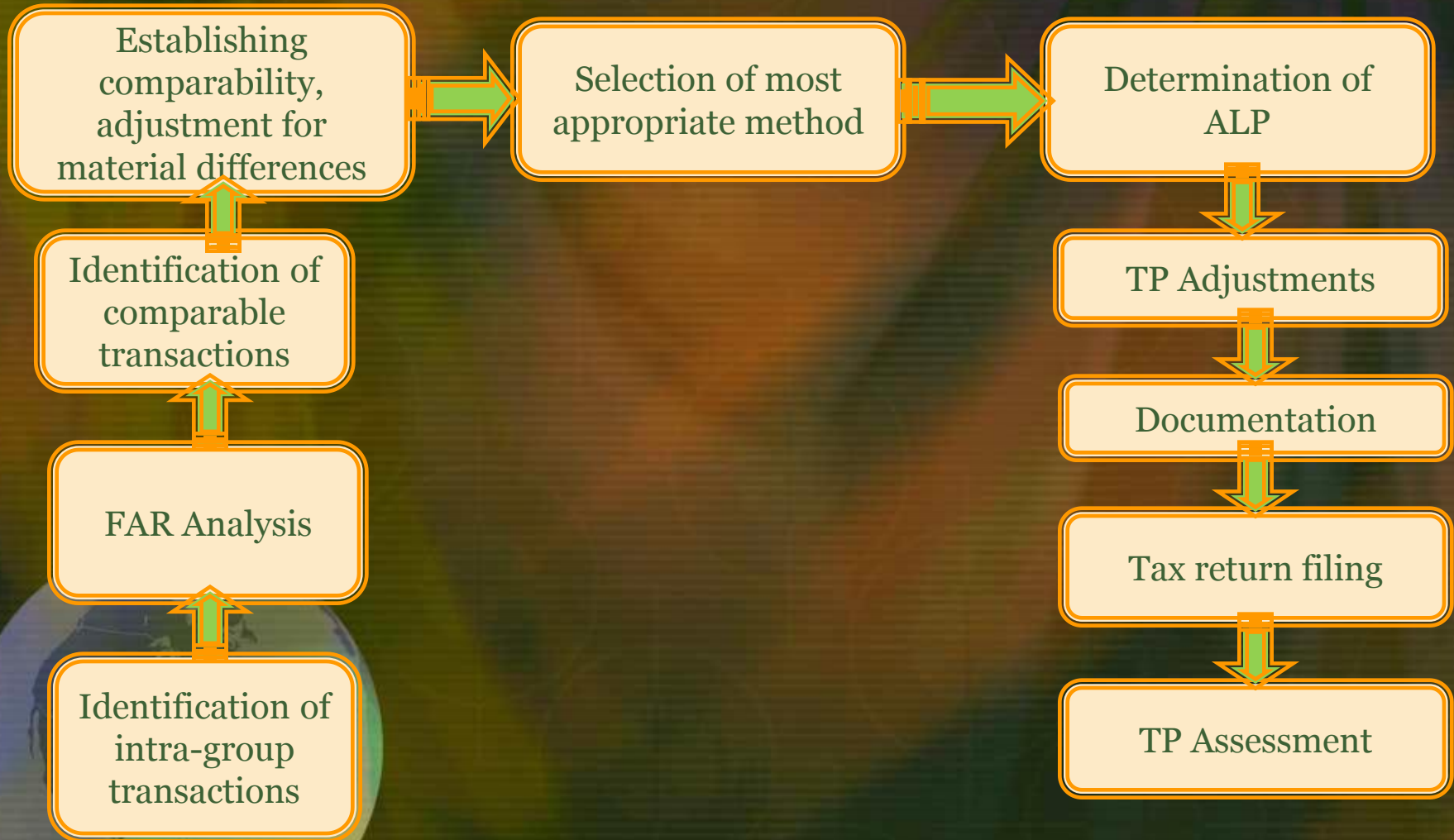


⌘ The Six methods:

- a) Comparable Uncontrolled Price Method (CUP)
- b) Resale Price Method (RPM)
- c) Cost Plus Method (CPM)
- d) Profit Split Method (PSM)
- e) Transaction Net Margin Method (TNNM)
- f) Rule 10AB - Any other method



Transfer Pricing Process



Advance Pricing Agreements (APA)

⌘ The Finance Act, 2012 has introduced 'APA Mechanism'

⌘ Salient Features –

⌘ Seeks to provide assurance of certainty and unanimity in transfer pricing approach followed by the tax authorities and taxpayers

⌘ Validity: Upto 5 years

⌘ Binding on tax authorities as well as taxpayers

⌘ Pre – Consultation process (with anonymous application option)



Indian TPR v OECD TP Guidelines



Meaning of AEs – As per Indian TPR

- ⌘ Section 92A – AE means direct or indirect participation in management control or capital:
 - by one enterprise into another enterprise; or
 - by the same person in both the enterprises

- ⌘ Equity holding, Control of Board of Directors/ Appointment of one or more Executive Director, mutual interest will also constitute Associated Enterprise

- ⌘ Either or both of Associated Enterprises should be non-residents



Meaning of AEs..

⌘ Deemed Associated Enterprises includes:

– Holding of 26% of voting power

⌘ by one enterprise into another enterprise; or

⌘ by the same person in both the enterprises

– Dependence on intangible assets

– Sale of goods

⌘ influence on price and conditions of supply by
buyer

– Control by individual or his relative

– Financial transaction

⌘ Loan - 51% or more of book value of total assets
of the borrowing enterprise

⌘ Guarantee - 10 % or more of the total
borrowings of an enterprise




Meaning of AEs as per OECD Model Tax Convention

⌘ Article 9(1) of OECD “ *Where direct or indirect participation in management, control or capital:*

⌘ *by one enterprise into another enterprise; or*

⌘ *by the same person in both the enterprises*

Then any profits which would accrue to either one of enterprises but have not accrued due to controlled conditions will be included in profits of that enterprise and taxed accordingly “



Whether definition of AE under domestic law can be reduced in rigor by falling under relevant article of AE under the treaty ?

Multiple Year Data

- ⌘ OECD Guidelines allow taxpayers the use of multiple year data
- ⌘ This is because the multiple year data generally captures market & business cycles and smoothens effects of yearly aberrations giving a better overall statistical result
- ⌘ However Indian TPR are counter intuitive and go against the international consensus by rejecting multiple year data generally



Use of Foreign Comparables

- ⌘ OECD Guidelines, in principle, recognize the use of foreign comparable by making suitable adjustments if there is material effect on price due to geographical differences
- ⌘ Indian TPR do not specifically prohibit foreign comparables
- ⌘ However revenue authorities have been reluctant to use overseas comparable laying strong preference for Indian comparables
- ⌘ In *Global Vantage India (P) Ltd v DCIT* the Delhi Bench of tribunal rejected selection of foreign party as tested party as geographical differences would make it difficult to establish comparability
- ⌘ In *Ranbaxy Laboratories v ACIT* the Delhi bench of tribunal accepted the use of foreign comparables as tested party



Transfer Pricing Methods

- ⌘ OECD has historically preferred traditional methods viz. Comparable Uncontrolled Transaction Method (CUP), Resale Price Method (RPM), Cost Plus Method (CPM) over transactional profit method viz. Profit Split Method (PSM) and Transactional Net Margin Method (TNNM), Rule 10AB – Any other method
- ⌘ However OECD's position has undergone a change in OECD TP Guidelines of July 2010, wherein OECD has treated all methods at par and has recommended the use of Most Appropriate Method (MAM) applicable



Transfer Pricing Methods

- ⌘ Thus OECD has in spirit accepted the Indian TPR's methodology to accept MAM, without laying emphasis on any particular method
- ⌘ But underlying preference for CUP can still be gathered from the revised OECD Guidelines
- ⌘ Even though Section 92C of Indian TPR do not prescribe preference over any particular method, tribunals in cases of *MSS India & Serdia Pharmaceuticals* laid preference on traditional methods over transactional profit methods




Applicability of Methods

- ⌘ The applicability of the methods depends on the nature of the transaction entered by the party
- ⌘ Same party – Different transaction – Different method



Range v Mean

- ⌘ The OECD TP Guidelines allow for a range of comparable data
- ⌘ However proviso to section 92C require computation of arithmetic mean (AM) if more than one price is determined by MAM
- ⌘ The second proviso to section 92C says that there will be no adjustment if variation between AM and International transaction does not exceed three percentage of the International Transaction.



Can all taxpayers conduct business transaction at a single mean price?

Compliance

⌘ Taxpayers covered under transfer pricing would have to maintain documentation as prescribed under section 92D

⌘ Documentation contain

- ⌘ Shareholding Structure
- ⌘ Group Structure
- ⌘ Industry Analysis
- ⌘ Nature of Specified domestic transaction
- ⌘ FAR Analysis
- ⌘ Selection and application of MAM
- ⌘ Comparability Analysis
- ⌘ Determination of ALP



Responsibility of The Taxpayer

| Sr. No. | Particulars | Section | Penalty |
|---------|---|-----------|----------------------------|
| 1. (a) | Failure to keep and maintain information or documentation | 271AA | 2% of value of Transaction |
| (b) | Failure to report such transaction | | |
| (c) | Furnishing incorrect information | | |
| 2. | Non-filing of Form 3CEB | 271BA | Rs. 1,00,000 |
| 3. | Failure to furnish documentation as required | 271G | 2% of value of Transaction |
| 4. | Concealment of Income with regards to Transfer Pricing | 271(1)(c) | 100% to 300% of tax evaded |

Trend of Assessments

| Financial Year | No. of TP Audits Completed | No. of Adjustment Cases | % of adjustment Cases | Amount of Adjustment (Crores) |
|----------------|----------------------------|-------------------------|-----------------------|-------------------------------|
| 2004-05 | 1,061 | 239 | 23 | 1,220 |
| 2005-06 | 1,501 | 337 | 22 | 2,287 |
| 2006-07 | 1,768 | 471 | 27 | 3,432 |
| 2007-08 | 219 | 84 | 39 | 1,614 |
| 2008-09 | 1,726 | 670 | 39 | 6,140 |
| 2009-10 | 1,830 | 813 | 44 | 10,908 |
| 2010-11 | 2,301 | 1,138 | 49 | 23,237 |
| 2011-12 | 2,638 | 1,343 | 52 | 44,531 |

*Source: White Paper May 2012, Ministry of Finance, Department of Revenue

Nuances



Risk of Economic Double Taxation

- ⌘ Transfer Pricing involves taxation of the same economic transaction both income and / or capital in the hands of two different tax payers in different countries
- ⌘ Hence risk of double taxation is the biggest problem arising from TPR
- ⌘ A proposed adjustment will lead to taxation of income earned by foreign AE in its jurisdiction of residence, while same income may be taxed in the hands of the other AE in a foreign jurisdiction



Secondary Tax Effects

- ⌘ In US and some other countries, if transfer prices are not consistent with ALS then it is deemed that secondary transaction has taken place
- ⌘ Secondary Tax effect would depend on relationship of parties and direction of reallocation of income
- ⌘ For eg. - If US subsidiary of foreign company purchases goods at higher prices from foreign parent company, the payment exceeding ALP will be deemed to be dividend distributed to parent company and such dividend is subject to withholding tax in US



Corresponding Adjustment

- ⌘ Company A and Company B are AEs situated in US and India respectively
- ⌘ Company B has purchased goods of Rs 100 from Company A out of which Rs.40 is considered excessive and downward primary adjustment of payment is made by Indian Revenue authorities, i.e. Indian Cos profit will increase by Rs 40
- ⌘ US IRS will make downward adjustment in income of Rs.40 of Company A after consultation with competent authorities in India



CASE STUDY

Advertising, Marketing and Brand Promotion Expenses



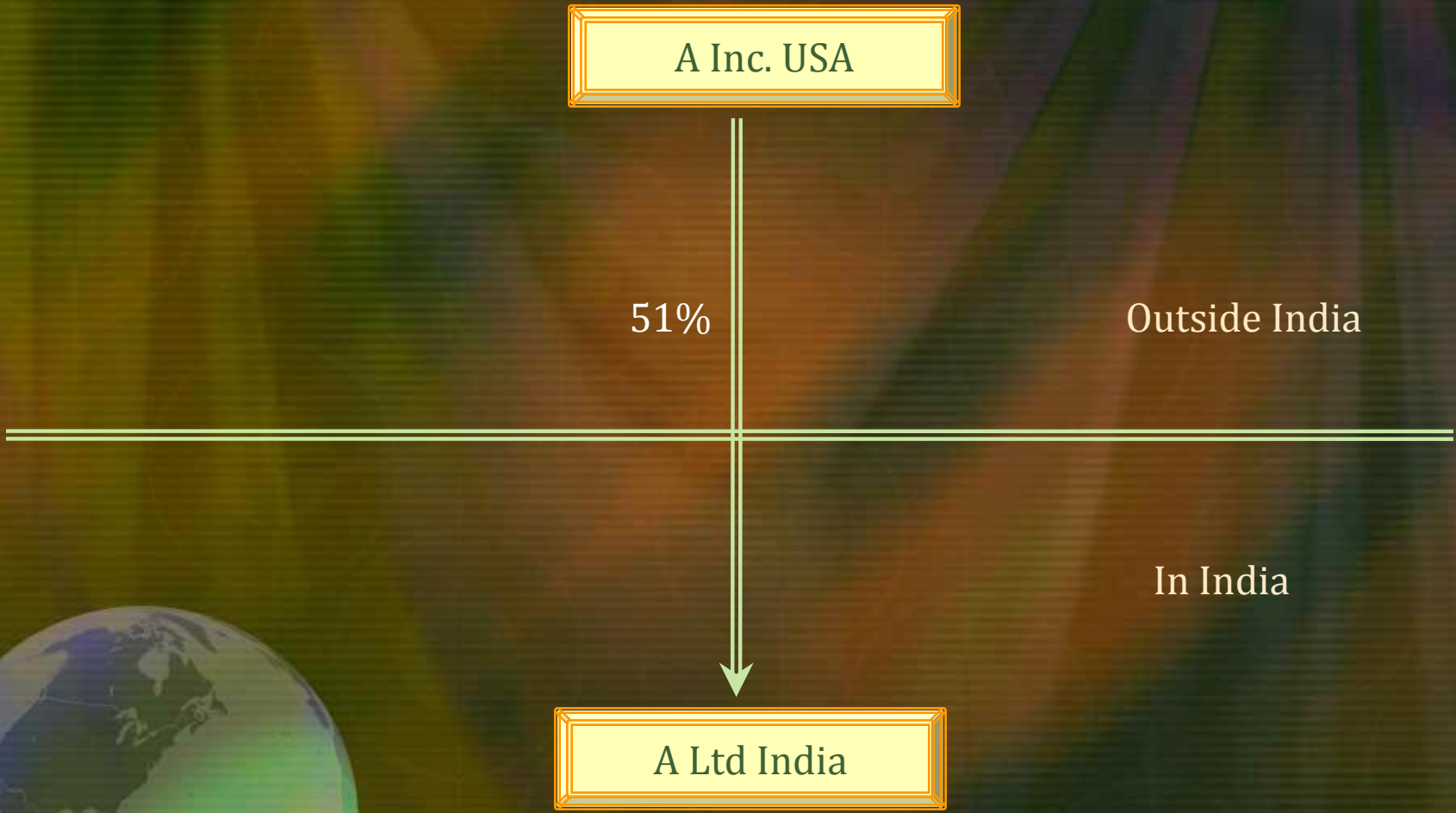
A Inc. USA

51%

Outside India

In India

A Ltd India



Case Study

- ⌘ A Inc USA was in the business of manufacturing fruit juices under brand name ' X '
- ⌘ A Inc incorporated a subsidiary A Ltd. to enter Indian markets
- ⌘ A Ltd manufactured juices and sold them in Indian market under brand name ' X '
- ⌘ A Ltd paid royalty on sales to A Inc. (AE) for use of brand ' X '
- ⌘ A Ltd incurred huge marketing expenditure to advertise and spread awareness about juice ' X ' in Indian market



Case Study

⌘ Actions by TPO :

⌘ He noticed the huge marketing expenditure incurred by A Ltd

⌘ Entire royalty payment to AE was disallowed on the premise that such payment was not required in light of huge marketing expenditure incurred by A Ltd.

⌘ It was held that A Ltd incurred such marketing expenditure in order to build AE's brand in India. TPO was of the view that A Ltd had provided a brand building service to its AE

⌘ A markup was added on such expenditure as such expenditure was termed as an international transaction



Case Study

⌘ Finance Act, 2012 has inserted explanation to Section 92B , thus retrospectively amending the definition of International Transaction to include:

“provision of services, including provision of market research, market development, marketing management, administration, technical service, repairs, design, consultation, agency, scientific research, legal or accounting service;”



Case Study

- ⌘ Was disallowance of royalty payment in light of marketing expenditure warranted?
- ⌘ Is marketing expenditure a service to AE?
- ⌘ Did such expenditure benefit AE?
- ⌘ Did A ltd. provided a service to its AE by incurring such expenses?



Case Study

- ⌘ Can local expenditure be re-characterised as international transaction?
- ⌘ What if the advertising expenditure is reimbursed by the AE and A Ltd. is provided with service fee for booking advertisements?

In US , Bright Line Test is used to benchmark development of marketing intangibles. Bright Line Test advocates comparison of Marketing Expenses/Sales Ratio of the tax payer with that of comparable companies for arm's length evaluation. Such test is not one of the prescribed methods given by Section 92C of the Act and cannot be said to be akin to TNMM

(ACIT v Genom Biotech - ITA No. 5272/Mum/2007)

(LG Electronics India Pvt Ltd v CIT - ITA No.5140/Del/2011)



THANK YOU

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